

***United States Court of Appeals
for the Second Circuit***



**BRIEF FOR
APPELLANT**

77-6005

In the
United States Court of Appeals
FOR THE SECOND CIRCUIT

DOCKET NO. 77-6005

SECURITIES INVESTOR PROTECTION CORPORATION,
Applicant,

U.S.

EXECUTIVE SECURITIES CORPORATION,
Defendant.

SECURITIES AND EXCHANGE COMMISSION,
Plaintiff,

U.S.

EXECUTIVE SECURITIES CORPORATION, ET AL.,
Defendants,

On Appeal from the United States District Court
for the Southern District of New York

BRIEF OF CLAIMANT—APPELLANT
YALE UNIVERSITY

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BRIEF OF CLAIMANT—APPELLANT
YALE UNIVERSITY

PRELIMINARY STATEMENT

This is an appeal from the decision and order of the United States District Court for the Southern District of New York, Charles H. Tenney, J., affirming the order of John J. Galgay, Bankruptcy Judge, which denied to Yale University status as a "customer" under Section 6(c) (2) (A) (ii) of the Securities Investor Protection Act of 1970. The District Courts' decision is reported at 423 F. Supp. 94.

STATEMENT OF ISSUE

Is Yale University a "customer" of Executive Securities Corporation within the meaning of the Securities Investor Protection Act of 1970 and therefore entitled to the preferred treatment afforded to "customers" thereunder?

STATEMENT OF THE CASE

PROCEEDINGS BELOW

This matter arises in a proceeding pursuant to the Securities Investor Protection Act of 1970 ("the 1970 Act"), 15 U.S.C. §§78aaa *et seq.* Upon application by the Securities Investor Protection Corporation ("SIPC") Judge Tenney of the United States District Court for the Southern District of New York determined on February 14, 1975, that the customers of Executive Securities Corporation ("Executive"), a securities broker-dealer, were in need of protection under the 1970 Act and appointed a trustee for the liquidation of the business of Executive. Two educational institutions and five broker-dealers filed claims in the proceeding on account of loans of securities which they had made to Executive. On June 12, 1975, the trustee notified the lenders of his determination that they were

not to be treated as "customers" as defined in the 1970 Act and that they would instead be treated as general creditors. Four of the lenders, including the two educational institutions, Yale University ("Yale") and Johns Hopkins University, and two of the broker-dealers, Dean Witter & Co. and Shearson Hayden Stone, Inc. ("Shearson") opposed the trustee's determination, and were heard on their claims before the Bankruptcy Judge. By order dated February 20, 1976, the Bankruptcy Judge affirmed the trustee's determination that the four lenders were not "customers" of Executive within the meaning of the 1970 Act.

Yale and Shearson appealed the order to the District Court, which on November 29, 1976, affirmed. This appeal by Yale, in which Shearson has joined, seeks a reexamination of the determination by the Bankruptcy Judge and the District Court that Yale is not entitled to "customer" status under the 1970 Act.

STATEMENT OF FACTS

Securities borrowed by broker-dealers play an important role in the settlement of securities transactions. When a broker-dealer is committed to deliver a security as agent or principal and does not have the security either because of the failure of its customer to deliver or because the security has been sold short, the broker-dealer frequently must borrow the necessary security to make delivery. Borrowings may be made from other brokers which hold securities pledged to them by their customers under margin hypothecation agreements. Another important source of borrowed securities, however, is the institutional investor such as Yale.

Yale initiated a securities loan program during its fiscal year 1972-1973, pursuant to which it entered into a written securities loan agreement with Executive on October 15, 1974. (JA p. 21a) Under the terms of the agreement Yale could lend securities to Executive which was required in turn to deliver cash collateral to Yale equal to 100% of the market value of the loaned securities on the date of delivery. During the term of securities loan, Executive was required to remit to Yale all dividends paid and all other distributions made by the issuer on the loaned securities. No interest was required to be paid by Executive on the cash collateral, but it was permitted to be used by Yale for any purpose, including investment in other income-producing securities. Upon demand of either party the cash collateral was required to be adjusted by "marking to market" so that the collateral could be made equal to 100% of the market value of the loaned securities. Either party could terminate a loan upon appropriate notice to the other party. In the event of a default by Executive, which would include commencement of a proceeding under the 1970 Act, Yale could treat the loaned securities as having been purchased by Executive at their market value on the date of default, in which case Yale would be entitled to retain an amount equal to the sales price from the cash collateral and to have a claim against Executive for the difference, if any, between the cash collateral and the market value of the securities.

When Executive was placed in liquidation under the 1970 Act on February 14, 1975, an event of default under the agreement, Yale notified Executive of its election to treat the loaned securities as having been purchased by Executive on the date of default. (JA p. 29a) Yale retained the \$200,000 cash collateral then in its possession as partial payment of the purchase

price for the loaned securities, which totalled \$266,700, and demanded payment of the balance of the purchase price, or \$66,700. Thus the amount of Yale's claim against Executive is \$66,700. (JA p. 30a)

The Bankruptcy Judge found and he and the District Court relied on the fact that Yale had not purchased the securities which were the subject of the loan through an account with Executive, and that Yale had not maintained a securities trading account with Executive at any time.

ARGUMENT

I.

INTRODUCTION: THE SECURITIES INVESTOR PROTECTION ACT OF 1970

Congress enacted the Securities Investor Protection Act of 1970, Public Law 91-598, effective December 30, 1970, "to provide protection for investors if the broker-dealer with whom they are doing business encounters financial troubles." H.R. Rep. No. 1613, 91st Cong. 2d Sess. 1 (1970). In brief, the 1970 Act (i) created the Securities Investor Protection Corporation, 15 U.S.C. §78ccc, as a private, non-profit corporation, (ii) provides for a SIPC Fund, 15 U.S.C. §78ddd, to be raised from member broker-dealers and used to compensate certain losses incurred by customers of failed brokers and dealers, and (iii) sets forth procedures for the application of the 1970 Act for the protection of customers of brokers and dealers determined by a federal court to have failed or to be in danger of failing to meet their obligations to customers, 15 U.S.C. §78eee. A failed broker or dealer is to be liquidated by a trustee in accordance with 15 U.S.C. §78fff.

Liquidation proceedings under the 1970 Act are generally patterned after Section 60e of the Bankruptcy Act, 11 U.S.C. §96(e), which was designed specifically for stockbroker bankruptcies. The provisions of the Bankruptcy Act apply to 1970 Act liquidations to the extent that such provisions are not inconsistent with or excluded by the 1970 Act, 15 U.S.C. §78fff(c) (1).

Of most importance in this appeal, the 1970 Act adopted the definition of "customers" contained in Section 60e of the Bankruptcy Act almost verbatim.¹ That definition, which is central to the disposition of this appeal, is set forth in Section 6(c) (2) (A) (ii) of the 1970 Act, 15 U.S.C. §78fff(c) (2) (A) (ii):

(A) Definitions.—Except as otherwise expressly provided in this section, for purposes of this section and the application of the Bankruptcy Act to a liquidation proceeding—

(i) . . .

(ii) "customers" of a debtor means persons (including persons with whom the debtor deals as principal or agent) who have claims on account of securities received, acquired, or held by the debtor from or for the account of such persons (I) for safekeeping, or (II) with a view to sale, or (III) to cover consummated sales, or (IV) pursuant to purchases, or (V) as collateral security, or (VI) by way of loans of securities by such persons to the debtor, and shall include persons who have claims against the debtor arising out of sales or conversions of such securities, and shall include any person who has deposited cash with the debtor for the purpose of purchasing securities, but shall not include any person to the extent that such person has a claim for property which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor or is subordinated to the claims of creditors of the debtor;

II.

**THE BORROWING OF SECURITIES BY BROKER-DEALERS
FROM INSTITUTIONAL INVESTORS SUCH AS YALE IS
ESSENTIAL TO THE FUNCTIONING OF THE
SECURITIES MARKETS.**

Loans between broker-dealers and their customers, similar to the loans by Yale to Executive, have historically played an important part in the functioning of the securities industry. Such loans are made by brokers, corporations, investment funds, and banks,² as well as by individuals.³

For an investor such as Yale, the loan of securities provides two benefits: first, he can increase his income from the securities by investing the cash collateral in short-term investments while continuing to receive payments from the borrower equal to the dividends and other distributions on the loaned securities; and second, the investor obtains hoped for appreciation in the market value of the loaned securities by receiving back the same number of shares that were loaned to the broker-dealer.

Securities loans serve several important functions in the operations of the securities markets. First, securities loans allow broker-dealers to make delivery in connection with short sales for other customers.⁴ Second, securities borrowings by odd-lot houses insure their ability to deliver odd-lots to other broker-dealers.⁵ Finally, these loans are frequently necessary to cure a broker-dealer's failures to receive securities that the broker-dealer is required to deliver to another party.⁶

The Securities and Exchange Commission has stressed the importance of encouraging institutional investors to make securities available for loans to settle securities transactions in

order to improve securities processing mechanisms and to reduce incompleting transactions.⁷

Therefore, securities lending is both a traditional and necessary part of the securities industry and a conservative method for investors to increase their income from securities they desire to keep in their portfolios.

The long-recognized and essential role of securities lenders in the proper functioning of securities markets explains why Congress included securities lenders within the definition of "customers" afforded protection under the 1970 Act. The Congressional policy underlying the treatment of securities lenders as customers under the 1970 Act was recently reaffirmed by the Senate Finance Committee in reporting on a bill which would have clarified the tax status of income received by exempt organizations from securities loans:

Because of time delays which a broker may face in obtaining securities to deliver to a purchaser (from the seller), brokers are frequently required to borrow securities from organizations with investment portfolios. In general, it is felt desirable that organizations (and individuals) with securities holdings should be encouraged to make them available for loan since the greater the volume of such securities available for loan the less frequently will a broker be in a position where he must fail to deliver a security to a purchaser within the time required by the relevant market requirements.⁸

III.

YALE IS A "CUSTOMER" OF EXECUTIVE WITHIN THE
DEFINITION CONTAINED IN THE 1970 ACT.

The relevant portion of the 1970 Act's definition of "customer" is:

"customers" of a debtor means persons. . . who have claims on account of securities received. . . by the debtor from. . . such persons. . . *by way of loans of securities by such persons to the debtor.* . . [Emphasis supplied.]

The 1970 Act has been characterized by the courts as confusing. See, e.g., *SEC v. Aberdeen Securities, Inc.*, 480 F.2d 1121, 1123 (3d Cir.), *cert. denied* 414 U.S. 1111 (1973). The definition of "customer," which was taken from the Bankruptcy Act, is clear and explicit, however. In applying that definition to Yale, this court should not allow itself to be confused by efforts to replace Congress' definition with one which better suits SIPC and minimizes the amounts it must advance (and therefore must raise from its member broker-dealers) to protect customers under the 1970 Act.

Rather, this court should be guided by a basic principle of statutory construction:

"The lawmaking body's own construction of its language, by means of definitions of the terms employed, should be followed in the interpretation of the act or section to which it relates and is intended to apply." 73 Am. Jur. 2d, Statutes, §225 (1974).

The following discussion sets forth certain basic observations concerning the definition and concludes with an analysis of the definition's application to Yale's loans of securities to Executive.

1. *The definition of "customer" is exclusive*

The definition of "customer" is an exclusive definition as a result of the use of the introductory word "means" rather than "includes" (" 'Customers' of a debtor *means* persons. . ."). The Supreme Court has held that the Bankruptcy Act does not use the words "include" and "mean" synonymously, *American Surety Company of New York v. Marotta*, 287 U.S. 513 (1933), which focused on the word "include" in the definition of "creditor" (" 'creditor' shall include anyone who. . .") in Section 1 of the Bankruptcy Act, 11 U.S.C. §1(11). The Supreme Court reviewed and analyzed the use of both "include" and "mean" throughout the Bankruptcy Act and held that "include" is generally a word of extension or enlargement, as opposed to "shall mean," which the court found was used to enumerate and restrict. 287 U.S. at 517. And see 8 *Collier on Bankruptcy* ¶2.02 (1976).

The significance of the distinction between "include" and "mean" is that the former permits the courts to resort to a common law meaning of the defined term, whereas the latter restricts the courts to the explicit, exclusive terms of the definition. When Congress passed the 1970 Act, it used the word "mean" in the definition of "customer," thereby clearly indicating that the definition was designed to be an explicit restriction upon those creditors who were to be "customers" protected under the 1970 Act.

To affirm the decision below, this court would have to ignore one of the explicitly listed categories of customers—those who lend securities to a broker-dealer—in derogation of the exclusive nature of the definition of "customer."⁹

2. *The definition of "customer" is transactional*

The definition of "customer" in the 1970 Act is designed to include those creditors of a broker-dealer who have had certain securities transactions with the broker-dealer. As a result, the definition focuses on specific transactions, which are listed under Roman numerals (I) through (VI) of the definition. It is important to note that the definition does not in any fashion restrict the type of *person* who can be a customer, but includes all persons who have claims resulting from any one of the enumerated transactions, one of which is loans of securities to a broker-dealer. Rather, the 1970 Act restricts the *amount* of protection afforded to any single person. 15 U.S.C. §78fff(f) (1), and see *SIPC v. Morgan, Kennedy & Co., Inc.*, 533 F.2d 1314, 1321 (2d Cir. 1976).

Thus, the 1970 Act protects any person, whether a small investor or a large institution, that has incurred a loss in connection with the transactions enumerated by Congress.

3. *Yale's loans of securities to Executive fall squarely within the transactions listed in Section 6(c) (2) (A) (ii) of the 1970 Act.*

Set out below is an analysis of how the 1970 Act's explicit definition of customer applies to the loans of securities by Yale to Executive.

Section 9(23) of the Bankruptcy Act, 11 U.S.C. §1(23), defines "persons" to include corporations. Section 6(c) (1) of the 1970 Act incorporates non-conflicting provisions of the Bankruptcy Act into the 1970 Act. As a result, Yale is clearly a "person" as that term is used in the definition of "customer."

The parenthetical clause at the beginning of the definition—“(including persons with whom the debtor deals as principal or agent)” —insures that customers include not only creditors for which the debtor broker-dealer was an agent (probably the most common relationship between a broker-dealer and its customer), but also creditors with whom the broker-dealer dealt as a principal, which was the case with Yale.

Yale is a person with a claim “on account of securities received. . . by the debtor from. . . such persons”—*i.e.*, the loaned securities received by Executive from Yale. And Executive received the securities from “such persons” (*i.e.*, Yale) “by way of loans of securities by such persons [Yale] to the debtor [Executive].”

In brief, Yale fits perfectly into clause (VI) of the definition: Executive received Yale’s securities “by way of loans” from Yale. Clause (VI) requires loans to be by the person making the claim (“by such persons”), presumably to exclude claims based upon unauthorized borrowings by a broker-dealer (such as where a broker “borrows” a customer’s shares for its own use, in which case the customer would undoubtedly fall within clauses (I) to (V)) or where the claimant is not the person who lent the shares. It is clear from Yale’s Security Loan Agreement with Executive that the loans in question were made by Yale to Executive.

The exclusion of certain loans by the final clause of the definition is inapplicable to Yale. The final clause excludes claims to property that by agreement or operation of law is part of the capital of the debtor or is subordinated to the claims of creditors of the debtor. That clause excludes certain loans and other transactions related to the ownership or financing of a broker-dealer. Yale’s loans of securities to Executive were clearly not the type of loans excluded.

Finally, there is no provision, express or implied, in the 1970 Act or elsewhere that restricts the application of the definition of "customer" so as to exclude Yale. Specifically, there is no requirement in the 1970 Act that a person must have a trading account with a broker-dealer in order to qualify as a "customer" or that the securities which are the subject of the loan must have been purchased through such an account. Nonetheless, the District Court states, ". . . a 'customer' is clearly limited to persons who maintain accounts with a broker-dealer and who trade or invest through them," citing as authority therefor the definition of "customer" in the 1970 Act and emphasizing the phrase "*from or for the account*" of the lender claimant. (JA p. 18a)¹⁰ In order to have reached its conclusion, the court below must have either ignored completely the words "from or" and given legal effect only to the words "for the account" or read the disjunctive "or" to mean "and." There is no justification whatsoever for such a strained construction, and no explanation is provided as to why such a construction was adopted.¹¹

Thus, the court below was completely without authority from either the express language of the statute or from its legislative history for engrafting onto the definition of "customer" a requirement that for a securities lender to qualify it must have first purchased the loaned securities *from the borrower*.¹² To impose such a requirement is to retreat to the uncertainties and confusion as to the rights of various classes of customers of a failed brokerage firm that prompted Congress to pass as part of the Chandler Act in 1938 the comprehensive definition of "customers" which has been carried over to the 1970 Act.¹³

It is for Congress to determine who should be protected under the 1970 Act. Congress has made that determination by enacting the definition of "customers" at issue in this appeal, and neither SIPC nor the courts should presume that Congress did not mean what it said in that definition. *Unexcelled Chemical Corp. v. United States*, 345 U.S. 59, 64 (1953). If SIPC believes that Congress's definition of "customers" is inappropriate or somehow inequitable, then that definition can be amended only by Congress.

Indeed, SIPC has sponsored legislation to amend the 1970 Act, and its proposed bill would, if enacted, amend the definition of "customers" by, among other things, deleting any reference to loans of securities.¹⁴ Congress has declined to enact such an amendment.

IV.

THE LEGISLATIVE HISTORY OF THE 1970 ACT SUPPORTS YALE'S CLAIM TO "CUSTOMER" STATUS.

In addition to falling within the plain words of the 1970 Act's definition of "customer," Yale is also the kind of customer that Congress intended to protect when it adopted that definition almost verbatim from Section 60e of the Bankruptcy Act.

The Senate and House Reports for the bills that became the 1970 Act establish that Congress intended the definitions taken from the Bankruptcy Act to have the same meanings as those definitions had in the earlier act:

"In addition, this bill uses certain terms defined in section 60e with the meaning there established, except as further defined in the bill." S. Rep. No. 1218, 91st Cong., 2d Sess. 10, 13 (1970); H.R. Rep. No. 1613, 91st Cong., 2d Sess. 20-21 (1970).

The courts have consistently recognized those earlier established definitions in applying the 1970 Act. See, e.g., *SEC v. F.O. Baroff Co., Inc.*, 497 F.2d 280, 282-283 (2d Cir. 1974).

It is necessary, therefore, to review the history of Section 60e of the Bankruptcy Act.

1. *Background to Section 60e of the Bankruptcy Act*

Section 60e was enacted in 1938 as part of the Chandler Act, which was a sweeping revision of the Bankruptcy Act "to modernize and bring up to date the bankruptcy law of our country." H.R. Rep. No. 1409, 75th Cong., 1st Sess. 3 (1937).

Subdivision *e* was added to Section 60 "in order to make uniform the rules applicable to the liquidation of the assets of bankrupt stockbrokers and to secure greater approximation to equality in distribution, especially to margin customers." *Id.* at 31. The need for "equality in distribution" grew out of the great complexity, diversity, confusion, and resulting inequities of the common law that had theretofore governed the rights of customers and other creditors in bankruptcy proceedings.

The most difficult problems under pre-Chandler Act law involved customers who had left securities in the possession of a stockbroker who later failed: by the time such a stockbroker was adjudicated a bankrupt, the securities had usually been pledged or otherwise disposed of by the stockbroker. In order to reclaim his securities, a customer was required to trace his specific certificates, a frequently impossible task, and to show that the stockbroker's use of the securities was improper. The problems were enormous and, for some customers, overwhelming.¹⁵ The customers most commonly affected by this predicament were the margin customers,¹⁶ although several

other classes of customers faced similar problems, including customers who had lent securities to the stockbroker.¹⁷

Margin customers faced the greatest difficulties due to the then prevailing rule that the broker was in effect the pledgee of a customer in a margin transaction (the so-called New York rule), *Richardson v. Shaw*, 209 U.S. 365 (1908), rather than the owner of the margin securities and thus the debtor of the margin customer (the Massachusetts rule). To the extent that a customer was a pledgor, the customer was not a creditor and thus did not receive the protections provided for creditors under the Bankruptcy Act. See H.R. Rep. No. 1409, *supra*, at 31.

But, as stressed by Professor James A. McLaughlin, the original draftsman of Section 60e, the possible distinctions among the various kinds of customers of a broker are innumerable:

If one approaches the problem from the point of view of customers, it is indisputable that the different degrees in which different customers trust the broker run through such a wide range that many possible distinctions might logically be taken. At the same time it is abundantly clear that the existing law turns upon refinements utterly unintelligible to the business man and involves elements of chance more appropriate to a beano party than to the administration of justice. If the problem be approached from the point of view of ease and economy of administration, the solution of the Chandler bill warrants a high rating.¹⁸

To remedy the "beano party" aspect of stockbroker bankruptcies, Section 60e was designed to eliminate the numerous, sometimes artificial, and always elaborate distinctions among the various classes of customers: first, by creating a single, broadly-defined class of customer-creditors, including securi-

ties lenders, Section 60e(1); second, by creating a single and separate fund comprised of the securities, and proceeds of securities, received, acquired, or held by the stockbroker from customers; and third, by applying the maxim that "equity is equality" and dividing the single and separate fund among all customers according to their respective net equities, Section 60e(2). As a result, customers were no longer required specifically to identify and trace their securities, but were entitled to share equally in all of the securities and proceeds of securities in the stockbroker's possession as of the date of bankruptcy.

The same basic liquidation procedures have been incorporated in the 1970 Act.

2. *The legislative history of and the policies underlying Section 60e support the inclusion of Yale as a customer of Executive*

The purposes of Section 60e of the Chandler Act and of the similar provisions of the 1970 Act are clearly revealed in the legislative histories of those statutes as well as in the available decisions and commentaries.¹⁹

As discussed above, Congress intended Section 60e to eliminate the complex and inequitable common law doctrines that required the customers of a bankrupt stockbroker specifically to identify and trace their securities in order to reclaim them from the bankrupt's estate:

[I]t is designed to get away from a lot of extremely technical, metaphysical rules about following the res. You talk about being theoretical. You get into the realm of medieval scholasticism if you try to follow through the alleged property rights that are seriously discussed and considered in the cases.²⁰

In its Report to Accompany H.R. 8046 (the bill enacted as the Chandler Act) the House Committee on the Judiciary stressed the attention given to the drafting of Section 60e:

The provisions of the subdivision [60e] have been carefully worked out, will do substantial justice, and be exceedingly helpful in declaring the law on a most difficult and troublesome subject.²¹

From the above it is clear that Congress drafted Section 60e, including the definition of customers in Section 60e(1), with great care and that Congress intended the words used in that definition to mean precisely what those words say—that “customers” include persons who lend securities to a broker-dealer.

The commentaries on the Chandler Act reinforce the above conclusion. For instance, John A. Gilchrist described the purpose of Section 60e as follows:

The primary objective of the draftsmen of sec. 60e of the Chandler Act was *to eliminate, as far as possible, the old classifications of customers inter sese*.²²

And Jacob I. Weinstein, who was directly involved in the drafting of Section 60e as a member of the Drafting Committee of the National Bankruptcy Conference, commented upon the definition of “customers” as follows:

This is a comprehensive definition designed *to cover every form of transaction dealt with under this subdivision*.²³

Similarly, the definition of “customers” was discussed as follows in a comment on Section 60e:

The first significant grouping of customers under the Chandler Act differentiates between those who are termed “cash customers” as defined in the Act, on the one hand, and *all others having claims on account of security dealings with the broker on the other*.²⁴

And again:

In a second division [other than cash customers] fall all other persons except general creditors, *whether margin customers or customers who had fully paid for their securities*, but who do not qualify as cash customers. This group is treated as a special group of creditors. . . .²⁵

There appear to be no reported decisions dealing with the status of securities lenders as customers under Section 60e, which is not surprising in light of the precise wording of the definition and the fact that the definition was intended to be comprehensive: there would have been no reason to deny customer status to securities lenders and thus no reason to litigate the issue.²⁶

3. *The policies underlying the 1970 Act support Yale's status as a customer of Executive*

Section 60e turned out to be an incomplete solution to the problems involved in broker-dealer bankruptcies. First, there were problems with the definitions of "stockbroker" (the definition did not refer to dealers) and of "customers" (it did not include those who deposited cash with a broker for the purchase of securities when the broker entered bankruptcy prior to making the purchase).²⁷ Second, the "serious and persistent financial problems besetting the securities industry" during the late 1960's, including the failure of several brokerage houses, threatened many customers with the loss of funds and securities, which in turn threatened to weaken public confidence in the U.S. securities markets.²⁸ These problems led Congress to pass the 1970 Act, which incorporated the basic provisions of Section 60e,²⁹ as discussed above.

In enacting the 1970 Act, Congress was primarily concerned with the related goals of protecting investors from certain losses resulting from the financial failure of broker-dealers and increasing the financial responsibility of broker-dealers: there is no evidence that Congress intended to alter Section 60e's inclusion of securities lenders such as Yale in the definition of "customers." To the contrary, Congress explicitly intended to incorporate Section 60e's definition of "customers" in the 1970 Act. S. Rep. No. 1218, 91st Cong., 2d Sess. 10, 13 (1970), and H.R. Rep. No. 1613, 91st Cong., 2d Sess. 20-21 (1970).

In adopting the definition of "customers" from Section 60e, Congress was carrying out its primary intent of protecting investors:

"The primary purpose of the reported bill is to provide protection for *investors* if the broker-dealer with whom they are *doing business* encounters financial troubles." H. Rep. No. 1613, 91st Cong., 2d Sess. 1 (1970), 3 U.S. Code Cong. and Adm. News, 91st Cong. 2d Sess., at 5255 (1970) (emphasis supplied).

The above expression of Congressional intent is consistent with the definition of "customers" in Section 6(c) (2) (A) (ii): there is no suggestion that in order to be a customer an investor must use a broker-dealer for trading purposes or that there must be a trading account or any other arbitrary, artificial requirement; rather, the 1970 Act is intended to protect investors *doing business* with a broker-dealer, and Section 6(c) (2) (a) (ii) explicitly lists the business transactions covered. It is beyond question that Yale is an investor and that Yale was doing business with Executive in at least one of the ways enumerated in the definition of "customers."

Further evidence that Congress intended securities lenders such as Yale to be included within the definition of "customers" is provided by Congress's addition of the final clause to Section 6(c) (2) (A) (ii):

["Customers"] shall not include any person to the extent that such person has a claim for property which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor or is subordinated to the claims of creditors of the debtor. . .

The above clause indicates Congress's awareness that certain financial dealings with broker-dealers should not be included in the transactions listed in Section 6(c) (2) (A) (ii), namely loans that are in reality contributions to capital or are subordinated to the claims of creditors, and thus not deserving of the priority given to the special class of creditors who are involved in the securities transactions listed in the definition of "customers." The specific exclusion of this particular kind of loan plainly reinforces the conclusion that other loans, such as Yale's, are included within the definition.

In addition to the plain words of Section 6(c) (2) (A) (ii), the policies underlying Section 60e of the Bankruptcy Act and the 1970 Act require the determination that Yale is a customer of Executive.

As discussed above, Congress intended Section 60e to put an end to the technical and inequitable common law rules previously applied to stockbroker bankruptcies by eliminating the old classifications of customers and treating all customers equally. In adopting the 1970 Act, Congress greatly expanded the protections afforded customers in order to restore public confidence in the securities markets by providing compensa-

tion to customers of failed broker-dealers and by increasing the financial responsibility of broker-dealers.

The exclusion of securities lenders like Yale from protection under the 1970 Act would contravene the above policies. First, such an exclusion would represent a return to the "beano party" atmosphere of pre-Chandler Act stockbrokerage bankruptcies by reimposing artificial classifications of customers according to administratively conceived distinctions among the various investors who do business with broker-dealers. Second, such an exclusion would deny protection to a class of investors who are clearly within the class of creditors that Congress, by its definition of "customers," intended to protect. Third, such an exclusion could deter securities loans in the future and thus weaken the financial responsibility of broker-dealers by increasing the incidence of fails to deliver and, as the SEC has noted, causing the breakdown of the mechanism for making short sales. In brief, such an exclusion would lessen public confidence in our securities markets and undermine the clear Congressional purpose of restoring such confidence.

Appellees and the courts below would, in effect, amend the Congressional definition of "customers" as it applies to securities lenders by adding the following requirements: first, a person who loans securities to a broker cannot be a "customer" unless he has a "trading account" with that broker; and second, the securities must have been lent from that trading account, not directly from the investor; and third, the securities must have been purchased from the broker to whom they are lent. None of the foregoing requirements are to be found in the 1970 Act or its legislative history. That such requirements would

contravene the basic Congressional goal of protecting investors is apparent from the following hypothetical situation:

Y is a blue collar worker who lives in New Haven, Connecticut, and neither owns securities nor has a relationship with any broker-dealer; Y inherits 1,000 shares of Anheuser Busch stock from his grandfather, who has previously urged Y to hold the shares for long-term appreciation; Y needs additional income and approaches a local broker-dealer, E, who offers to borrow Y's stock pursuant to a standard security loan agreement with 100 percent cash collateral, which Y can invest and mark to market, while Y will receive from E amounts equal to dividends on the loaned stock, and Y agrees; while the loan is outstanding, the stock appreciates; unfortunately, broker-dealer E then fails and is liquidated under the 1970 Act; Y files a claim for his loss (market value as of the date E failed less collateral).

If this court were to adopt the reasoning of appellees and the courts below, Y would not be a "customer" of E and would be excluded from the protections of the 1970 Act: Y had no "trading account" and did not purchase his stock through E. Such a result is not required by the 1970 Act and would contravene the Congressional policy of increasing public confidence in the securities markets by protecting the customers of failed broker-dealers up to the amounts prescribed by the 1970 Act (\$50,000 for lost securities and \$20,000 for cash losses).

V.

**THE BAROFF CASE DOES NOT APPLY TO A LOAN OF
SECURITIES MADE IN CONNECTION WITH BOTH THE
LENDER'S AND THE BORROWER'S PARTICIPATION IN
THE SECURITIES MARKETS.**

There appears to be no reported decision concerning the status of a securities lender such as Yale as a customer of a broker-dealer under Section 60e of the Bankruptcy Act or under the 1970 Act.

The Supreme Court has decided only one case under the 1970 Act. *SIPC v. Barbour*, 421 U.S. 412, 95 S. Ct. 1733 (1975), reversing *SEC v. Guaranty Bond & Securities Corp.*, 496 F.2d 145 (6th Cir. 1974). The *Barbour* decision did not deal with the definition of "customers," although the Supreme Court did recognize and emphasize that the Congressional purpose in passing the 1970 Act was to restore investor confidence in the capital markets and upgrade the financial responsibility of broker-dealers. 421 U.S. at 415.

This Court of Appeals has decided one case which dealt with a related question concerning the application of the "customer" definition to a lender of securities to a broker-dealer. *SEC v. F. O. Baroff Company, Inc.* (Claim of Samuel Lubin), 497 F.2d 280 (1974). Lubin "lent" securities to a broker-dealer ("Baroff") to help Baroff out of a "cash bind" by allowing Baroff to use the lent securities to borrow cash needed to alleviate its financial problems. 497 F.2d at 281. Lubin did not receive consideration for his "loan," nor did he receive any collateral or other benefit. *Id.* Following the commencement of the liquidation of Baroff under the 1970 Act, Lubin made a claim to "customer" status under that Act, which claim was

denied by the trustee, the Bankruptcy Judge, and the District Court, primarily on the ground that Lubin's "loan" was in fact a contribution to the capital of Baroff and thus excluded by the last clause in the definition of "customer."

The Second Circuit stated the question before it as follows:

[W]hether a voluntary lender of securities to a failing brokerage house, who made his loan *to help out the company and not for a purpose related to securities trading or investments*, qualifies under the Act's scheme.³⁰

In their briefs to this court, Lubin, the trustee, and SIPC argued two subsidiary questions: (i) whether Lubin was a "customer" under Section 6(c)(2)(A)(ii)(VI) in connection with his loan of securities; and (ii) if so, whether he was excluded from customer status by the last clause of that definition, dealing with contributions to capital. In reaching the conclusion that Lubin was not a customer of Baroff for purposes of the 1970 Act, Judge Davis professed to answer the first question only, although in fact he combined the two questions:

We need not decide [the second] question, but we note that this exclusion, even if technically inapplicable in this instance, throws light on the preceding segments of the definition. To use Chairman Budge's words . . . , Congress was intent on protecting "the public customers of the firms" and in avoiding "a bailout operation" for others, including those who contributed to the capital of the broker-dealer. There is no reason to think that non-investing, non-trading creditors—or gratuitous lenders acting through pure benevolence, family relationship, or friendship — were to be better off under the Act than capital-contributors.³¹

Judge Davis went on to rest his opinion on Lubin's lack of investment intent in making his loan to Baroff:

Appellant's loan of the 7,000 Electronic Transistor shares to Baroff does not meet this criterion of intent to use the lent securities (or their proceeds if hypothecated) in some type of securities trading or investment activity. *On the facts before us, the loan had nothing at all to do with conventional investment, trading or participation in the securities market.* . . .³²

Judge Davis also stressed that Lubin's arrangement, whereby he gave Baroff permission to hypothecate the lent securities for cash, was analogous to a cash loan to the broker-dealer, which "would obviously be outside of the Act's definition of 'customers' which covers cash deposits only if they are 'for the purpose of purchasing securities.' We can think of no reason why the Congress which passed the statute would desire to protect this loan of securities by appellant but not a straightforward cash loan made by him with the very same goal." 497 F.2d at 284.

The result in *Baroff* is consistent with pre-Chandler Act decisions that denied priority treatment to creditors who made gratuitous loans to brokers out of friendship or family loyalty, see *In re Stringer*, 233 F. 799 (E.D.N.Y. 1916) (a woman who had lent shares to her stockbroker brother to alleviate his financial difficulties was not accorded customer status), just as Yale's status as a customer (*i.e.*, a priority creditor) under Section 60e and the 1970 Act would be consistent with pre-Chandler Act law, see *In re Archer, Harvey & Co.*, 289 F. 267, 272-275 (D. Md. 1923) (Claim of Mrs. Ricker), where a person who had borrowed cash from a stockbroker and left securities as collateral was treated as a customer in order to reclaim her securities.

The important distinctions between the facts of *Baroff* and of this appeal are (i) that Executive borrowed the Yale securities pursuant to a written agreement that expressly required the securities to be used to satisfy Executive's obligations for delivery of securities as a part of Executive's business in trading securities in the securities market; (ii) that Yale's loans of securities to Executive were part of Yale's own investment activities in connection with the management of its portfolio of securities and were neither a contribution to Executive's capital nor a method of helping Executive through financial difficulties; and (iii) that Yale's loans of securities were not gratuitous, but were collateralized by cash, which Yale could and did invest as part of its total investment program (JA 33a-34a). Yale's loans of securities were not analogous to commercial loans. (A commercial loan with 100 percent cash collateral would be absurd.)

In short Yale's loans of securities fall squarely within the traditional framework of loans made to broker-dealers by investors as one of the securities transactions listed in Section 6(c)(2)-(A)(ii) of the 1970 Act.³²

Although the facts at issue in *Baroff* are dissimilar to the facts of the present appeal, *Baroff* nevertheless provides valuable guidance in resolving the issue presented herein. In *Baroff*, the court considered the primary criterion for customer status to be whether or not there was an "intent to use the lent securities (or their proceeds if hypothecated) in some type of securities trading or investment activity." 497 F.2d at 284 (emphasis supplied). Lubin's loan did not satisfy that criterion. Yale's securities loans to Executive do satisfy that criterion. It is indisputable from the record (JA pp. 33a-34a) and from the

Bankruptcy Judge's findings (JA pp. 6a-7a) that Yale's intent in making the securities loans was solely to increase Yale's investment income from its portfolio of securities. Yale's intent was intimately tied to its participation in the securities markets and the management of its investments.

Finally, there is no indication in the *Baroff* opinion that this court intended to give lower courts a *carte blanche* to disregard the language of the 1970 Act whenever a security lender asserts its right to customer status under the plain language of Section 6(c)(2)(A)(ii)(VI). Yet that is precisely what the courts below have done in this case.³⁴ Obviously, courts are not obligated to apply statutory language slavishly if such an application would frustrate the patent purpose of the statute. *Cabell v. Markham*, 148 F.2d 737, 739 (2d Cir.), *affirmed* 326 U.S. 404 (1945) and cases cited therein. But just as obviously, courts may not disregard Congress's statutory language when there is ample evidence that Congress meant what it said and the language is consistent with the underlying policy of the statute. The Supreme Court has specifically rejected the use of policy arguments to override the explicit language of Congress:

Arguments of policy are relevant when for example a statute has an hiatus that must be filled or there are ambiguities in the legislative language that must be resolved. But when Congress, though perhaps mistakenly or inadvertently, has used language which plainly brings a subject matter into a statute, its word is final — save for questions of constitutional power which have not even been intimated here.³⁵

VI.

YALE'S ALLEGED LACK OF DILIGENCE IN "MARKING TO MARKET" IS NOT AN ISSUE.

The District Court cited with approval the view of the Bankruptcy Judge that any loss suffered by Yale "relates to [its] failure to monitor the value of the loaned securities and insist upon additional cash collateral." (JA pp. 12a-13a)

The above allegation and its implications are untenable. First, there is no evidence in the record and no finding of fact that in any way supports the conclusion that Yale lacked diligence in marking to market: there is no evidence that Yale knew, or should have known, of Executive's impending demise, or that Yale had any duty to require Executive to mark to market at any set frequency, or at all. Second, Yale's diligence in marking to market is irrelevant to Yale's status as a customer under the 1970 Act: nowhere in the 1970 Act or its legislative history is there the slightest suggestion that only the diligent are to be protected. Third, if lack of diligence were to be added to the criteria that Congress has set forth in Section 6(c)(2)(A)(ii), then any customer could be denied the protections of the 1970 Act simply by a showing that the customer "lacked diligence" by leaving cash or securities with a shaky broker-dealer.

Congress could have adopted a diligence standard if it had thought such a requirement wise or relevant. Congress did not impose such a requirement, and neither should SIPC or the courts.³⁶

CONCLUSION

For the foregoing reasons the judgment appealed from should be reversed and the Bankruptcy Court ordered to allow the claim of Yale as a "customer" under the 1970 Act, with all of the rights and privileges of such a customer.

Respectfully submitted,

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FOOTNOTES TO BRIEF

¹ The 1970 Act added to the definition of "customers" a clause to include customers who have deposited cash with a debtor for the purpose of purchasing securities and a clause to exclude claims relating to property that is part of the capital of a debtor or that is subordinated to the claims of creditors of a debtor.

² See Securities and Exchange Commission, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., Pt. II, 249 (1963) (hereinafter "SEC Special Study"):

At one time brokers interested in making such arrangements congregated in a so-called "loan crowd" at a designated place on the floor of the Exchange. Among the principal lenders were large corporations, investment funds, and even banks who were represented by their own brokers. Sometimes the loans were made at premiums providing the lenders with extra income. Today a premium is extremely rare; it may be charged if a "short squeeze" develops in the stock, as it might in a stock with a large short interest and a limited floating supply of shares.

³ See, e.g., *In re T.A. McIntyre & Co.* (Appeal of Mary H. Hudson), 181 F. 955 (2d Cir. 1910), and *In re Archer, Harvey & Co.* (Claim of Mrs. Ricker), 289 F. 267 (D.Md. 1923); and see generally Oppenheimer, "Rights and Obligations of Customers in Stockbrokerage Bankruptcies," 37 Harv. L. Rev. 860 (1924).

⁴ "The short selling mechanism would break down but for the availability of stock for borrowing in order to make delivery." SEC Special Study, Pt. II at 249.

⁵ SEC Special Study, Pt. II at 176:

According to the odd-lot firms, this stock borrowing serves two purposes: first, to insure that they will be able to make timely delivery when selling odd lots to member firms and, second, to insure that certificates in small denominations are on hand so as to "make change" on deliveries by member firms.

⁶ See Regulation T of the Federal Reserve Board, 12 CFR §220.6(h).

⁷ 76-26 Tax Mngm't. Memo (BNA) 7 (Dec. 20, 1976):

The Securities and Exchange Commission (SEC) has indicated to the Revenue Service that the availability of institutional portfolio securities for lending would reduce the number of uncompleted transactions in the securities markets. The SEC opinion was given to the Revenue Service in support of ruling requests made by institutional investors to clarify the tax status of payments made to them for lending such securities.

The SEC opinion referred to above was given in the form of two letters from Ray Garrett, Jr., Chairman of the Securities and Exchange Commission, to Donald C. Alexander, Commissioner of Internal Revenue, dated April 2, 1974, and March 19, 1975. For the convenience of the Court, both letters are reprinted in the appendix to this brief.

⁸ S. Rep. No. 1266, 94th Cong., 2d Sess. 4, *reprinted in* [1976] U.S. Code Cong. & Ad. News 5863, 5866.

⁹ A statutory definition supersedes common law and dictionary definitions as well as personal preferences. The Bankruptcy Act, from which the definition of "customers" was derived, contains several definitions that may not comport with everyday usage, but which do reflect some underlying Congressional intent. For example, "conceal" is defined to include "falsify and mutilate" (§1(7) of the Bankruptcy Act), "cor-

poration" includes unincorporated bodies and associations (§1(8)), "persons" include corporations and partnerships (§1(23)), and "wage earner" is limited to those with compensation not exceeding \$1,500 per year (§1(32)). See 1 *Collier on Bankruptcy* ¶1.00[2] (1976).

- ¹⁰ The court's footnote 2 (JA p. 20a), cited as the basis for the quoted statement, reads:

Section 6(c) (2) (A) (ii) states in pertinent part:

"(II) 'customers' of a debtor means persons . . . who have claims on account of securities received, acquired, or held by the debtor *from or for the account of* such persons . . . (VI) by way of loans of securities by such persons to the debtor. . . ." (Emphasis supplied).

- ¹¹ "Indeed, it is a cardinal rule of statutory construction that significance and effect should, if possible, without destroying the sense or effect of the law, be accorded every part of the act, including every section, paragraph, sentence or clause, phrase, and word." 73 Am. Jur. 2d, Statutes, §250 (1974) (footnotes omitted). See also 82 C.J.S. Statutes §343 (1953).
- ¹² "Claimants purchased securities elsewhere before loaning them to Executive; their claims fail, *not* because they are not *investors* in the securities market, but because their securities were not lent in connection with trading or investment *through* Executive." Memorandum of Tenney, J., JA p. 17a. (Emphasis in original)
- ¹³ See the discussion below of that legislative history, pp. 14-23. An example of the confusion invited by the District Court's position might be this situation. Suppose Yale were to have purchased 100 shares of General Motors from Executive and added them to its securities portfolio, but without having left them with Executive. Later Yale loans 100 shares of General Motors to Executive at a time when Yale holds 2,000 shares in its portfolio. Must Yale identify the 100 shares

loaned as those purchased from Executive in order to qualify as a "customer" in respect of that loan transaction? Plainly the 1970 Act imposes no such requirement, although perpetuation as law of the view of the District Court would seem to require "tracing" of the securities purchased to those loaned.

¹⁴ H.R. 8064, 94th Cong., 1st Sess. §6 (1975) (referred to Comm. on Interstate and Foreign Commerce), and S. 1231, 94th Cong., 1st Sess. §6 (1975) (referred to Committee on Banking, Housing, and Urban Affairs). Both bills died in committee.

¹⁵ See, e.g., *In re J.C. Wilson & Co.*, 252 F. 631 (S.D.N.Y. 1917), and *In re Archer, Harvey & Co.*, 289 F. 267 (D.Md. 1923); Hagar, "The Bankruptcy Law as Applied to Stockbrokerage Transactions," 30 Yale L.J. 488 (1921); Oppenheimer, Rights and Obligations of Customers in Stockbrokerage Bankruptcies," 37 Harv. L. Rev. 860 (1924); and McLaughlin, "Amendment of the Bankruptcy Act," 40 Harv. L. Rev. 341 (1927).

¹⁶ See, e.g., *In re Toole*, 274 F. 337 (2d Cir. 1921), and generally Smith, "Margin Stocks," 35 Harv. L. Rev. 485 (1921), and Note, "The Rights of a Customer in Collateral Security Given a Stockbroker," 22 Colum. L. Rev. 155 (1922).

¹⁷ The following, written in 1924, describes some of the numerous kinds of transactions that can lead to customer status, including securities loans:

A, the broker, deals in securities for customers B, C, D, E, F, G, H, and I. B orders A to purchase 100 shares of Osmo stock, and gives him the purchase price. C gives A 100 shares of Osmo stock to sell for him. D orders A to purchase for him 100 shares of Osmo stock, but instead of paying the purchase price, leaves A other securities as collateral. E orders A to sell 100 shares of Osmo stock for him "short"—that is, E does not give A the stock at the time of the order. F asks A to buy 100 shares of Osmo

stock for him "on margin"—that is, F pays only a part of the purchase price at the time of the order, and agrees to leave the stock bought with A until the balance is paid. G orders A to buy for him 100 shares of Osmo stock on the partial payment plan, whereby G pays so much down and so much a week, A retaining the stock until it is paid for. *H brings in his 100 shares of Osmo stock as security for money to be lent to him by A.* I has bought and fully paid for his 100 shares of Osmo stock, but leaves the certificate with A for safekeeping. [Emphasis supplied.]

Oppenheimer, "Rights and Obligations of Customers in Stockbrokerage Activities," 37 Harv. L. Rev. 860, at 861 (1924). H, a security lender under modern terminology, could take before general creditors under certain circumstances. *Id.* at 873-875. This article was one of the first major analyses of the complex legal problems facing the customers of a bankrupt stockbroker.

¹⁸ McLaughlin, "Aspects of the Chandler Bill to Amend the Bankruptcy Act," 4 Univ. of Chic. L. Rev. 369, 397 (1937), and quoted in Hearings on H.R. 6439 and 8046 Before the House Comm. on the Judiciary, 75th Cong., 1st Sess., ser. 9, at 130 (1937).

¹⁹ It should be noted, however, that a statute, when couched in unambiguous language, fully expresses the intent of Congress. See 82 C.J.S., Statutes, §316(a) (1953). Nevertheless, the legislative history of Section 60e and the 1970 Act is consistent with the plain words of Section 6(c) (2) (A) (ii) (VI) of the 1970 Act and the treatment of Yale as a customer of Executive.

²⁰ Testimony of Prof. J. A. McLaughlin, original draftsman of Section 60e, Hearings on H.R. 6439 and H.R. 8046 before the House Committee on the Judiciary, 75th Cong., 1st Sess., ser. 9, at 126 (1937). See McLaughlin, "Aspects of the Chandler Bill to Amend the Bankruptcy Act," 4 Univ. of Chic. L. Rev. 369 (1937), for a discussion of the origins of the Chandler Act.

- ²¹ H.R. Rep. No. 1409, 75th Cong., 1st Sess. 31 (1937). The Senate report did not discuss the substance of Section 60e and referred to the House Report for details. Sen. Rep. No. 1916, 75th Cong., 3rd Sess. 2, 5 (1938).
- ²² Gilchrist, "Stockbrokers' Bankruptcies: Problems Created by the Chandler Act," 24 Minn. L. Rev. 52, 53 (1939) (emphasis supplied).
- ²³ Weinstein, *The Bankruptcy Law of 1938: A Comparative Analysis* 123 (1938) (emphasis supplied).
- ²⁴ Comment, "The Bankrupt Stockbroker: Section 60(e) of the Chandler Act," 39 Colum. L. Rev. 485, 491 (1939) (emphasis supplied).
- ²⁵ *Id.* at 492 (emphasis supplied).
- ²⁶ In addition, broker-dealer insolvencies were rare prior to the late 1960's: between 1938 and 1961, no member of the New York Stock Exchange was declared bankrupt. Loss, *Securities Regulation* §1191 (2d Ed. 1961).
- ²⁷ SEC Special Report, Pt I at 410-414. See also Gilchrist, "Stockbrokers' Bankruptcies: Problems Created by the Chandler Act," 24 Minn. L. Rev. 52 (1939).
- ²⁸ H.R. Rep. No. 1613, 91st Cong., 2d Sess. 2 (1970).
- ²⁹ *Id.* at 20-21. See also Sen. Rep. No. 1218, 91st Cong. 2d Sess. (1970).
- ³⁰ 497 F.2d at 281 (emphasis supplied).
- ³¹ 497 F.2d at 284.
- ³² *Id.* (emphasis supplied).

- ³³ In fact, the trustee in *Baroff* took pains to distinguish Lubin's loan from traditional securities loans made by investors like Yale:

The third category of loans from a person not previously a customer requires that the lender receive cash collateral and that his account be "marked to market" daily.

Significantly, these agreements all include elements of consideration to the lender and provisions designed to define the rights of the parties and protect the lender in the event of the borrower's default. The Lubin arrangement has virtually none of these provisions but is patterned after a gratuitous transfer. Lubin's failure to protect himself or to require collateral for the loan is a clear line of demarcation between the Lublin loan and those typical in the industry.

Brief for Trustee-Appellee at 20, *SEC v. F. O. Baroff Company, Inc.*, *supra*.

- ³⁴ In its opinion below, the District Court quoted with apparent approval from an earlier decision by the Bankruptcy Judge below (J.A. p. 20a):

In another bankruptcy proceeding, *SEC v. Howard Lawrence & Co., Inc.*, 74 Civ. 193, (S.D.N.Y. Feb. 14, 1975), Judge Galgay considered the claim of Mr. Ralph Smith, who had loaned securities to a failed broker-dealer in order to enable it to meet a commitment to another customer. Mr. Smith maintained an active trading account with the broker-dealer. The court recognized the applicability of the principles enunciated in the *Baroff* decision and affirmed the Trustee's rejection of the claim: "*We have discarded the literal interpretation of the word 'customers' to conform to the general policy of the Act. Mr. Smith, in order to be protected, must have made the loan pursuant to his position as an investor in securities.*" *Id.* [Emphasis supplied.]

³⁵ *Unexcelled Chemical Corp. v. United States*, 345 U.S. 59, 64 (1953).

³⁶ Such a requirement would, of course, contravene the basic purpose of the 1970 Act, which is to restore confidence in the securities markets by protecting customers against losses resulting from broker-dealer failures. It clearly was not Congress's intent to force customers to act in such a way as to undermine the financial stability of broker-dealers by withdrawing their securities from the custody of broker-dealers. The principal draftsman of Section 60e of the Bankruptcy Act explicitly recognized the difficulties that would be raised by a diligence requirement:

If the problem be approached from the point of view of ease and economy of administration the solution of the Chandler Bill warrants a high rating. Apart from weaknesses that may lurk in the imperfections of draftsmanship inevitably to be suspected when attempt is made at a partial codification of law governing complicated commercial transactions, the Bill is probably most vulnerable to temperate criticism from the point of view of those who would insist upon priority for cash customers who are *diligent* in seeing that their cash transactions are executed. As Mr. Glenn has sagely remarked, however, *any reasonable man ought to know that a broker's office is no place to leave money or securities for safe-keeping*. [Emphasis supplied]

Prof. J. A. McLaughlin, Hearings on H.R. 6439 and H.R. 8046 before the House Comm. on the Judiciary, 75th Cong., 1st Sess., ser. 9, at 131, quoting from McLaughlin, "Aspects of the Chandler Bill to Amend the Bankruptcy Act," 4 Univ. Chic. L. Rev. 369, 398 (1937).

APPENDIX TO BRIEF

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

OFFICE OF THE CHAIRMAN

April 2, 1974

Honorable DONALD C. ALEXANDER
Commissioner of Internal
Revenue Service
Department of the Treasury
1111 Constitution Avenue, N.W.
Room 3000
Washington, D. C. 20224

Re: Availability of Corporate Securities for Lending to
Facilitate Settlement of Securities Transactions

Dear Mr. Alexander:

The availability of securities for lending to facilitate the settlement of securities transactions is a matter of some concern to the securities industry. Because current and future tax policies may have some bearing on this matter, I am taking this opportunity to apprise you of the situation and its ramifications.

When a broker-dealer sells a security as agent for a customer, it settles the transaction by receiving the security from the customer and redelivering it to the appropriate clearing facility or directly to the buyer. On the other hand, when a broker-dealer purchases a security as agent for a customer, it receives the security from the clearing facility or directly from the seller, or its agent, and redelivers it to the customer, in

general, after transferring the security into the customer's name. In either event, if the broker-dealer fails to receive the security, it likely will not be able to deliver it, unless other identical securities of the same issuer are readily available for borrowing. Similar situations occur when the broker-dealer is acting as principal rather than as agent.

These situations may arise from a variety of circumstances, including, among others: the customer's securities are in "legal form" and must first be transferred into "good deliverable form"; the customer has not sold his entire holdings and must have the certificates broken down into smaller denominations for delivery; or the seller has sold the securities short. One of the most common reasons, however, is that the seller or his broker-dealer has itself failed to receive the security from a previous seller. (For example, customer X of Broker A sells to Marketmaker B, who sells to Trader C, who sells to Broker D for its customer Y; if customer X fails to deliver to Broker A, as a consequence, four additional incomplete transactions may be created.) It was the realization of this possibility of an initial failure to complete a transaction to create a continuous chain of incompleting transactions that was one of the primary causes of the securities processing crisis of the late 1960's and early 1970's.¹

Over the last few years the Securities and Exchange Commission and the securities industry self-regulatory organizations (the stock exchanges and the National Association of Securities Dealers, Inc.) have instituted a number of reforms designed to improve the processing of securities transactions

¹ See, Securities and Exchange Commission, *Study of Unsafe and Unsound Practices of Brokers and Dealers*, H.R. Doc. No. 92-231, 92d Cong., 1st Sess. (1971).

and thus to reduce incompleting transactions. The level of incompleting transactions between broker-dealers may be reduced through the use of sophisticated clearing facilities by netting transactions among participants and thereby reducing the number of securities movements which are necessary to complete transactions and eliminating chains of incompleting transactions.² Such clearing facilities or depositories, however, cannot reduce the level of incompleting transactions where the parties to such transactions are not members of these clearing facilities or depositories but rather are customers of broker-dealers or, the particular securities are not cleared through any clearing facility or included in a depository. Thus, many such incompleting transactions are unavoidable. Even so, if the broker-dealer obligated to deliver a security can borrow an identical security from another holder, and use the borrowed security to make delivery, at least a chain of incompleting transactions may be avoided. And, when the original security is received, the borrowed security can be returned.

Consequently, the Commission believes that the borrowing of securities to settle securities transactions can, depending upon the circumstances, be a useful and desirable technique to improve the securities processing mechanism and reduce incompleting transactions. The rules promulgated by the Board of Governors of the Federal Reserve System appear to foster such an approach, since those rules permit broker-dealers to borrow securities for the purpose of making deliveries of such

² Depositories also reduce securities movements by holding large amounts of securities and effecting delivery between participants solely by book entry and without the necessity for actual receipt and delivery of certificates by the participants.

securities, without regard to the margin limitation otherwise imposed by Regulation T.³

The borrowing of securities by broker-dealers to complete deliveries, to avoid "fails" and to cover short sales is thus quite extensive. The New York Stock Exchange reports, for example, that, at the end of December, 1973, its members had outstanding borrowings of securities of approximately \$1 billion.

A principal obstacle to increasing the borrowing of securities appears to be the limited supply of such securities available for loan. A portion of the securities currently borrowed are securities in customers' margin accounts and the supply, we are advised, is not adequate to meet demand because a large percentage of common stocks and most corporate bonds are held by institutional investors, primarily pension funds, investment companies and insurance companies.

We understand that, with the very recent exception of insurance companies, these institutional investors have not been lenders of securities because of their doubts about the tax status of the payments that would be made to them. These payments include not only the borrowing fee, but also any payments made in lieu of dividends, interest and other distributions by the issuer of the securities.⁴ The characterization of those payments for income tax purposes may be determinative of whether it is profitable for various types of institutional investors to make securities loans. If the source of such bor-

³ See 12 CFR 220.6(h).

⁴ Since the broker-dealer has redelivered the security to its purchaser and is not the holder of record, it is not in a position to flow through the actual distribution to the lender and can only make a payment in lieu of it.

rowings is inhibited or eliminated because institutional investors will incur adverse tax consequences if they lend their securities, both the level of incompleting transactions could increase and the ability to effect short sales could be reduced. On the other hand, to the extent an increased amount of borrowable securities is available, it is quite possible that the current level of incompleting transactions could be further reduced.

We are advised that a number of such investors may have filed, or may be about to file, requests for revenue rulings to resolve the question with respect to the proper classification of such payments. These requests involve complicated provisions of the Internal Revenue Code and of tax policy as to which the Commission, of course, does not have any expertise. If, however, favorable revenue rulings are issued, thereby encouraging institutional investors to lend their securities, based on the current volume of fails, knowledgeable members of the brokerage industry estimate that substantial additional borrowings could take place, significantly reducing "fails" in the securities markets. This would improve the efficiency of the clearance and settlement functions in these markets with resulting savings for the securities industry, which needs to operate as efficiently as it can in order to discharge its responsibilities.

We hope that this background information will be useful to the Internal Revenue Service in considering any requests for rulings you have received or may receive on this important subject.

Sincerely yours,

Ray Garrett, Jr.
Chairman

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

OFFICE OF THE CHAIRMAN

March 19, 1975

Honorable DONALD C. ALEXANDER
Commissioner of Internal
Revenue Service
Department of the Treasury
1111 Constitution Avenue, N.W.
Room 3000
Washington, D. C. 20224

Re: Availability of Corporate Securities for Lending to
Facilitate Settlement of Securities Transactions

Dear Mr. Alexander:

Last year, the Commission determined that I should write to you to advise you of its views with respect to the availability of corporate securities for lending to facilitate the settlement of securities transactions. At that time, we were aware that some institutional investors were contemplating requesting revenue rulings to clarify the tax status of the payments that would be made to them if they were to lend securities. Since that time, we understand that requests have been made for revenue rulings by at least some institutional investors who, in the absence of a favorable ruling, have indicated their reluctance to become lenders of securities.

As I indicated to you in my prior letter, the Commission, of course, is not purporting to express any opinion on matters of tax policy or any interpretation of the Internal Revenue Code.

We do believe, however, that favorable rulings could result in substantial additional borrowings, significantly reducing "fails" in the securities markets and, concomitantly, could improve the efficiency of the clearance and settlement functions in these markets with resulting savings for the securities industry. Since the time of my first letter, the aggregate dollar value of "fails" has decreased, due to the important strides that have been made over the last five years by the Commission and the securities industry to maintain regulatory control over this situation. Nevertheless, the very recent increase in trading activity we have been witnessing has been accompanied by an increase in the dollar value of fails generally; a favorable tax ruling would permit these fails to be reduced by the lending of securities, augmenting continuing regulatory efforts. Indeed, since our last letter, the dollar value of fails in the corporate bond area has increased by at least ten percent, and this particularly is an area where the corporate lending of securities could prove most salutary.

In light of our interest in this matter, the Commission would appreciate it if you could apprise us of the current status of any requests you have received on this matter. Naturally, if we can be of any assistance to you in your consideration of this matter, you should feel free to call upon us.

Sincerely yours,

Ray Garrett, Jr.
Chairman

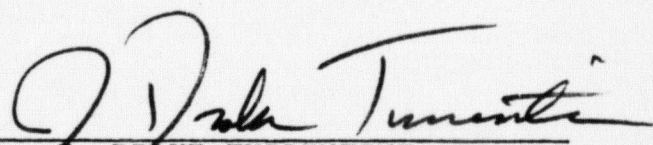
CERTIFICATE OF SERVICE

I, J. DRAKE TURRENTINE, attorney for Yale University, hereby certify that on this 18th day of February 1977, I served two copies each of the Brief of Claimant - Appellant Yale University and the Joint Appendix upon the following persons by depositing a copy thereof in the United States mails, post paid, addressed to them as indicated below:

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J. DRAKE TURRENTINE